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Watch Transfers of Life Insurance Policies

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Watch Transfers of Life Insurance Policies

-by Neil E. Harl*

Typically, the mention of transfers of life insurance policies in an estate planning context raises questions of whether the proceeds are (or will be) subject to federal estate tax¹ or state inheritance or state estate tax, how insurance policies are handled in a trust or otherwise where the decedent-insured possessed fiduciary powers over the policy,² or the treatment of split-dollar policies.³ However, the transfers of policies *during life* can encounter significant tax consequences as well. Those potential tax consequences are the focus of this article.

The possibility of reportable income

As is well known, the payment of life insurance proceeds *after the death of the insured* does not result in the proceeds being subject to income tax⁴ other than for some transfers of policies for valuable consideration.⁵ So-called "viatical settlements" whereby amounts are received under a life insurance contract on the life of an insured who is "terminally ill"⁶ or "chronically ill"⁷ are treated as paid by reason of the death of the insured with no income tax imposed.⁸

But what about other transfers of policies during life? If a life insurance policy is surrendered to the insurer for the available cash value, to the extent the fair market value of the life insurance policy exceeds the policy's income tax basis (based on premiums paid), the amount of the proceeds over which the taxpayer-insured has control or receives an economic benefit otherwise, is subject to tax as ordinary income.⁹

EXAMPLE: a \$100,000 policy (face value) taken out in 1950 and surrendered in 2010 has been observed to have a total death benefit of roughly \$114,000 and a total surrender value of about \$105,000. The premiums paid totaled approximately \$22,000. The difference between the premiums paid and the surrender value (approximately \$83,000) would be ordinary income if the policy is surrendered by the policy owner.

What about a transfer of the policy to a charitable organization?

If the insured does not obtain control or receive an economic benefit from the proceeds, the charitable deduction is limited to the income tax basis of the policy.¹⁰ That is consistent with the general rule that, with limited exceptions¹¹ income tax deductions for contributions of "ordinary income property" are limited to the income tax basis for charitable purposes.¹² That is why a contribution to a charitable organization of a load of shelled corn valued at \$3,500 but with an income tax basis of zero is not entitled to a charitable deduction. The income tax basis of such commodities ordinarily has an income tax basis of zero inasmuch

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as the costs of production have been or will be deducted on Schedule F (or other business schedule). For gifts of grain or raised livestock to a charitable organization, the costs of production are deductible¹³ regardless of whether the contribution occurs in the year of production or a later year.¹⁴ The result, in the above example, would be to limit the charitable deduction to the premiums paid or approximately \$22,000.

In a 1965 Sixth Circuit Court of Appeals case, *Friedman v. Commissioner*,¹⁵ the taxpayer was apparently aware of that outcome so the taxpayer sold endowment policies to a charitable organization (a synagogue) for the income tax basis in the policies and made a gift of the excess value to the charity. The court noted that the taxpayer received an economic benefit by control over and the disposition of the policies, resulting in realization of taxable income. The purported gift of the “excess value” was treated as taxable as to the increased value of the policies over the income tax basis.¹⁶

If the policy is redeemed by the insured with control over the proceeds, followed by a gift of the policy proceeds to a charitable organization for income tax purposes, a charitable deduction could be claimed for the amount of the payment. However, through 2009, the Congress imposed a reduction (of up to 20 percent) of itemized deductions including charitable contributions for high income taxpayers who itemize.¹⁷ The American Jobs and Closing Tax Loopholes Act of 2010,¹⁸ as passed by the United States House of Representatives on May 28, 2010 did not contain an extension of that provision beyond 2009, at least not as passed by the House. Inasmuch as this is a revenue raising measure, there are political reasons why it might not have been included thus far in the legislative process. Certainly anyone contemplating such a procedure should be made aware of the uncertainty of whether a reduction of itemized deductions might be imposed for tax years after 2009.

Other situations

Proceeds of life insurance on the life of a debtor payable to a creditor are also not received by reason of death¹⁹ and do not escape income tax but are received in satisfaction of the obligation. To the extent that the satisfaction of the obligation would produce income, so do the insurance proceeds.²⁰

In early 1965, IRS held that a discount for prepayment of life insurance premiums was not income.²¹ Subsequently, the Service refined its position to state that any increment in value applied to the payment of premiums due on annuity or life insurance policies, or made available for withdrawal by the policyholder, would be taxable income.²² Thus, “advance premiums,” or “premium deposit funds,” can produce ordinary income.²³

In conclusion. . .

Any transfer of a life insurance policy during the life of the insured merits careful planning. The treatment is dramatically

different from the treatment of transfer of the proceeds after the death of the insured.

ENDNOTES

¹ See I.R.C. § 2042. See generally 5 Harl, *Agricultural Law* § 43.02[7] (2010); Harl, *Agricultural Law Manual* § 5.02[5] (2010).

² See, e.g., *Skifter v. Comm’r*, 468 F.2d 699 (2d Cir. 1972) (proceeds not taxable where decedent-insured was trustee but court found powers could not have been exercised for decedent-insured’s economic benefit).

³ See Treas. Reg. §§ 1.61-2(d)(2)(ii). See also Rev. Rul. 2003-105, 2003-2 C.B. 696 (prior guidance rendered obsolete).

⁴ I.R.C. § 101(a).

⁵ I.R.C. § 101(a)(2).

⁶ I.R.C. § 101(g)(1)(A).

⁷ I.R.C. § 101(g)(1)(B).

⁸ I.R.C. §§ 101(g)(1), 101(a).

⁹ See *Friedman v. Commissioner*, 346 F.2d 526 (6th Cir. 1965), *aff’g*, 41 T.C. 428 (1963).

¹⁰ See Treas. Reg. § 1.170A-4(b)(1).

¹¹ See I.R.C. § 170(e) (a charitable deduction is allowed, within limits, for food inventory and, through 2005, for books to public schools).

¹² *Id.*

¹³ I.R.C. § 162.

¹⁴ Treas. Reg. § 1.170A-1(c)(4). That is not the case for gifts of commodities to non-charitable donees. See Rev. Rul. 55-138, 1955-1 C.B. 223; Rev. Rul. 55-531, 1955-2 C.B. 520.

¹⁵ 346 F.2d 526 (6th Cir. 1965), *aff’g*, 41 T.C. 428 (1963).

¹⁶ *Id.*

¹⁷ I.R.C. § 68.

¹⁸ H.R. 4213, 111th Cong., 2d Sess. (2010).

¹⁹ I.R.C. § 101(a).

²⁰ *Landfield Finance Co. v. United States*, 418 F.2d 172 (7th Cir. 1969).

²¹ Rev. Rul. 65-24, 1965-1 C.B. 31.

²² Rev. Rul. 65-199, 1965-2 C.B. 20, *revoking* Rev. Rul. 65-24, 1965-1 C.B. 31. See Rev. Rul. 66-120, 1966-1 C.B. 14.

²³ See 1 Harl, *Farm Income Tax Manual* § 2.02[2][j] (2010 ed.).